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No. 91-1586

In The

Supreme Court of the United States

October Term, 1991

SUPER VALU STORES, INC.,

Petitioner,

vs.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Respondent.

Petition For Writ Of Certiorari To The Supreme Court Of Iowa

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTIONS PRESENTED FOR REVIEW

1. Whether this Court has jurisdiction because the federal question was neither properly raised in nor considered by the Iowa Supreme Court.

2. Whether the Due Process and Commerce Clauses require that a nondomiciliary corporation's income from intangibles earned, in part, directly from activities in the taxing state must be wholly allocated to the corporation's commercial domicile.

3. Whether the Due Process and Commerce Clauses require that diverse business components be considered nonunitary, even if their financial and managerial links produced economies of scale and flows of value.

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STATEMENT OF THE CASE

1. Relevant Facts.

Super Valu is a corporation whose commercial domicile is in Minnesota. Super Valu was engaged in a wholesale food business in 28 states. In Iowa, it operated a wholesale warehouse and two company-owned retail grocery stores during the tax year in question. (Pet. App. 27a-28a). Super Valu also owned 26 subsidiaries, 24 of which were in the wholesale food business or provided services to that business. One of the other two subsidiaries was County Seat whose commercial domicile was in Minnesota and which operated specialty retail clothing stores. (Pet. App. 27a, 30a). During the taxable year, County Seat operated 10 stores in Iowa. (Pet. App. 28a).

County Seat was established in 1973 as a division of Super Valu. By 1976, it grew to 80 stores. In 1976, Super Valu established County Seat as a separate corporation and transferred to it assets having a fair market value of $23,900,343. In payment for this transfer, about $1,000,000 was treated as paid-in capital and County Seat issued a $22,900,343 seven-year promissory note. (Pet. App. 3a, 12a, 28a). This note was not timely paid. (Pet. App. 12a).

Super Valu and County Seat had some common officers and directors, none of whom was active in the day-to-day management of both corporations. There were few transfers of employees between Super Valu and County Seat. (Pet. App. 4a). Super Valu's and County Seat's principal offices were in the same Minnesota location, but they did not share any other business locations. (Pet. App. 30). They did not share any brand names, logos, or

other indicia of identification. (Pet. App. 4a). Both corporations had separate organizational structures. (Pet. App. 29a).

Super Valu and County Seat did not purchase for the other any inventory, supplies, or equipment and had separate product distribution systems and warehouses. They did not have a uniform credit card system nor did they honor the other's product warranties, guarantees, or customer complaints. (Pet. App. 29a). They did not share advertising, research, or product development. (Pet. App. 29a-30a).

In other respects, however, their relationship was interwoven. (Pet. App. 5a-6a, 11a-12a, 30a-35a). Super Valu provided financial and managerial services to County Seat, including cash management, guarantor of County Seat leases, payroll processing, employee retirement and stock option, insurance, legal, internal audit, tax return preparation, and accounting. (Pet. App. 33a-35a). Short-term borrowing and short-term investment activities by Super Valu provided working capital to Super Valu and all of the subsidiaries. The Iowa Supreme Court found that it was reasonable "to conclude that County Seat's success was a direct result of this financial nurturing by Super Valu." (Pet. App. 12a).

Super Valu sold its County Seat stock on May 25, 1984 and realized a long-term capital gain of $41,067,700. In its Iowa tax return for its taxable year ending February 23, 1985, Super Valu allocated this capital gain wholly to Minnesota as a nonbusiness capital gain. On audit, the Iowa Department of Revenue and Finance (Department)

determined that the capital gain was apportionable business income and assessed the tax in dispute. (Pet. App. 25a).

2. Iowa Corporation Income Tax.

Iowa Code § 422.33 imposes the tax upon corporate "net income" as defined in Iowa Code § 422.35. Section 422.33 divides net income into two fundamental types. Iowa Code § 422.33(2)(a) provides for an "arms-length" allocation, either wholly within or wholly without Iowa, of a multistate corporation's "nonbusiness income" as defined in Iowa Code § 422.32(7). The parties agree that this income includes nonunitary income. If the capital gain from the sale of County Seat stock constituted nonbusiness income, the capital gain is wholly allocated to Super Valu's commercial domicile in Minnesota pursuant to § 422.33(2)(a)(4). (Pet. App. 65a-67a).

The other type of net income constituted "business income" as defined in Iowa Code § 422.32(6). (Pet. App. 65a). The parties agree that business income includes the taxpayer's unitary income. Capital gains which are business income are expressly included in the preapportioned net income base under Iowa Code § 422.33(2)(b)(2). (Pet. App. 66a-67a). All business income is attributable to Iowa by an apportionment formula, which is not at issue in this case.[1]

The Iowa business income and nonbusiness income concepts adopt the unitary business principles developed

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[1] The Iowa single sales factor formula was upheld by this Court in *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

by this Court in Due Process and Commerce Clause cases associated with extraterritorial taxation in defining allocable income and apportionable income. But, the allocation of nonbusiness income wholly within or wholly without Iowa, in Iowa statutory law, is not constitutionally mandated in every situation. Even if activities occur in Iowa which directly relate to the generation of nonbusiness capital gain income on behalf of a nondomiciliary corporation from the sale of intangible property, Iowa statutory law allocates that income wholly to the commercial domicile. The allocation statutes with respect to income from intangibles of nondomiciliary corporations do not consider the actual income-producing activities in Iowa. *See also* Iowa Administrative Code, rules 701-54.4 and 54.2. (Pet. App. 68-69).

3. Proceedings Below.

In the administrative litigation before the Department, the only fighting issue was whether the capital gain resulting from the sale of County Seat stock was apportionable business income or allocable nonbusiness income under Iowa statutory law. (Pet. App. 39a). There was no significance attached to County Seat's Iowa activities. The parties did not present any constitutional extraterritorial evidence in the record nor did they urge them in their respective lengthy briefs. Super Valu's brief, served on May 24, 1988, states that "[T]his case concerns the proper treatment under Iowa law of Super Valu's capital gain on the sale of the County Seat stock." (Br. App. A at 1a). Since the parties presented the issue in terms of whether Super Valu and County Seat had a unitary relationship,

the Department's decision applied the principles articulated by this Court in unitary cases associated with constitutional claims of extraterritorial taxation, but the decision did not address any constitutional issue. (Pet. App. 39a-64a). The Department's Director held that the capital gain was apportionable business income because he found that Super Valu and County Seat had a unitary relationship.

When Super Valu sought judicial review in the Polk County District Court, it asked that a Due Process and Commerce Clause issue of extraterritorial taxation be decided. The Department resisted this improper attempt to present a constitutional issue. (Br. App. B at 5a-6a). The District Court's decision affirmed the Department's unitary finding, but did so only within the framework of Iowa statutory law. (Pet. App. 15a-16a).

On appeal to the Iowa Supreme Court, Super Valu sought to raise an extraterritorial constitutional issue. Again, the Department resisted this attempt. (Br. App. C at 8a-9a). The Iowa Supreme Court's decision carefully examined the facts involving the Super Valu-County Seat relationship, tracked the appropriate legal principles employed by this Court in unitary cases, determined that there were economies of scale and flows of value that inhere in a unitary business in that relationship, and upheld the unitary finding. (Pet. App. 1a-12a). The Iowa Supreme Court did not consider the significance of the County Seat stores in Iowa.

SUMMARY OF ARGUMENT

Super Valu, a food wholesaler, asks this Court to determine that its entire capital gain derived from its sale of a wholly-owned subsidiary, County Seat, a clothing retailer, should be allocated to its Minnesota commercial domicile to avoid alleged extraterritorial taxation on the theory that it lacked a unitary business relationship with County Seat. Super Valu only attacks the tax base, and not the income apportionment formula.

This Court should deny certiorari in this case for three reasons. First, Super Valu did not properly present nor did the Iowa Supreme Court pass upon the question of whether Iowa's tax constituted unconstitutional extraterritorial taxation. Super Valu failed to exhaust its administrative remedy in that it did not submit a constitutional extraterritorial taxation claim in the administrative litigation. Instead, it postured its case within the context of Iowa statutory law which provided for full allocation of nonbusiness income from intangibles to a nondomiciliary corporation's commercial domicile, even if that income was earned, in part, from activities in Iowa. The administrative and lower court decisions did not consider nor pass upon a constitutional issue of extraterritorial taxation.

Second, the federal question presented by Super Valu for full income allocation to Minnesota is insubstantial and baseless because a portion of the capital gain was generated by County Seat's Iowa activities consisting of its 10 Iowa stores. This Court's prior unitary decisions which involved Due Process and Commerce Clause extraterritorial taxation issues have never authorized full

income allocation by a nondomiciliary corporation of income that was produced, in part, by a nexus of income-producing activities in the taxing state. The record in this case is inadequate to reach a conclusion that Iowa over-taxed.

Third, the Iowa Supreme Court carefully employed the correct legal standards and considered the relevant facts in making its unitary finding. The financial and managerial integration between Super Valu and County Seat produced economies of scale and flows of value indicative of a unitary relationship. There is no good reason why this Court should second-guess the Iowa Court's decision. The diversity of Super Valu and County Seat did not, in this case, require a nonunitary finding.

REASONS FOR DENYING THE WRIT

I. SUPER VALU FAILED TO RAISE AND THE IOWA SUPREME COURT DID NOT CONSIDER A DUE PROCESS OR COMMERCE CLAUSE FEDERAL QUESTION OF EXTRATERRITORIAL TAXATION.

In Iowa, a taxpayer challenge to an income tax assessment must be initially presented to the Department for adjudication as a precondition for judicial review, even if a facial constitutional issue is involved. *Shell Oil Co. v. Bair*, 417 N.W.2d 425, 429-30 (Iowa 1987).

In the administrative litigation, Super Valu and the Department noted that the issue was whether the capital gain was business income or nonbusiness income as demarcated in Iowa statutory law. The Department's

decision noted that the issue was whether the capital gain was apportionable business income or allocable nonbusiness income (Pet. App. 39a) and held the gain was business income because the Director found that a unitary relationship existed between Super Valu and County Seat. No significance was attached to County Seat's Iowa activity.

In Iowa, one must state with particularity the details of a claimed constitutional transgression. *McSpadden v. Big Ben Coal Company*, 288 N.W.2d 181, 184 (Iowa 1980). This was not done in the administrative adjudication. Consideration of a unitary question in the context of resolving a statutory issue does not demonstrate that a constitutional issue of extraterritorial taxation was properly raised or decided. *Beck v. Washington*, 369 U.S. 541, 549-50 (1962).

Super Valu's attempt to first present the constitutional extraterritorial issue for adjudication in the District Court was improper. In Iowa, the District and Appellate Courts function in an appellate capacity to review action of Iowa administrative agencies, including the Department. *Klein v. Iowa Department of Revenue and Finance*, 451 N.W.2d 837, 839 (Iowa 1990); *Richards v. Iowa Department of Revenue*, 360 N.W.2d 830, 831 (Iowa 1985). "In reviewing agency action, the district court and the appellate court may only review issues considered and decided by the agency." *Grudle v. Department of Revenue and Finance*, 450 N.W.2d 845, 847 (Iowa 1990); *see Hope Evangelical Lutheran Church v. Iowa Department of Revenue and Finance*, 463 N.W.2d 76, 82 (Iowa 1990), *cert. denied*, 111 S.Ct. 585 (1991).

Where state procedures require exhaustion of administrative remedies and failure to raise an issue in the administrative proceeding precludes the raising in or consideration by the state courts of that issue, this Court will not review the issue on certiorari. *Jimmy Swaggart Ministries v. Board of Equalization of California*, 493 U.S. 378, 397-99 (1990). "Failure to present a federal question in conformance with state procedure constitutes an adequate and independent ground for decision barring review in this Court, so long as the State has a legitimate interest in enforcing its procedural rule." *Michigan v. Tyler*, 436 U.S. 499, 512 n.7 (1978). Iowa has an obvious legitimate interest in enforcing the doctrine of exhaustion of administrative remedies. *Jimmy Swaggart* at 397.

The Iowa Supreme Court noted Due Process and Commerce Clause prohibition on extraterritorial taxation. (Pet. App. 7a). That Court also relied upon this Court's precedents, in particular, *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), in resolving the unitary question. However, neither these nor any other portions of that Court's opinion demonstrate that the Court was making a constitutional adjudication which, in light of the exhaustion doctrine, would have been inappropriate. The Court's opinion was consistent with its task to determine, under Iowa income tax statutes, whether the capital gain was business income or nonbusiness income on the basis of whether a unitary relationship between Super Valu and County Seat existed. The Court's statement that "[I]f the businesses are not unitary, any gain on the sale would be included in Super Valu's return in the state of its domicile, Minnesota" is only consistent with an allocation of nonbusiness income

under § 422.33(2)(a)(4), and not with an extraterritorial constitutional adjudication.[2] (Pet. App. 7a). Iowa's allocation of intangible income to "commercial domicile" under § 422.33(2)(a)(4) is not merely synonymous with a constitutional rule as "there is nothing talismanic about the concepts of 'business situs' or 'commercial domicile' that automatically renders those concepts applicable when taxation of income from intangibles is at issue." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 445 (1980).

The Iowa Supreme Court did not pass upon a constitutional question. This Court has no jurisdiction over this case.

II. THE FEDERAL QUESTION PRESENTED BY SUPER VALU IS INSUBSTANTIAL.

Super Valu has never placed in issue Iowa's method of formula apportionment. Super Valu's decision "to attack the tax base rather than the formula substantially narrows the issues before" this Court so that the Court should "not consider whether application of [Iowa's] formula produced a fair application of [Super Valu's capital gain] income to" Iowa. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 434 (1980).

The real constitutional issue presented by Super Valu is whether "any portion of the gain of a nondomiciliary corporation attributable to the sale of the stock of a subsidiary" could be taxed by Iowa if Super Valu and

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[2] In point of fact, Super Valu treated the capital gain as apportionable income in its Minnesota return for the taxable year in question.

County Seat lacked a unitary relationship. (Pet. 7). Super Valu ignores any impact upon this issue caused by County Seat's operation of 10 stores in Iowa. Yet, that impact defeats Super Valu's constitutional claim of full non-Iowa income allocation.

Super Valu's ability to earn the capital gain depended upon County Seat's business activities. Those activities contributed to the worth of the County Seat stock. The physical presence of the income-producing asset, County Seat, in Iowa by itself satisfies the due process requirement of nexus. "The simple but controlling question is whether the state has given anything for which it can ask return." *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940). It is obvious that a portion of the capital gain could constitutionally be attributed to Iowa because of a nexus between Iowa and the capital gain.

The instant case is not akin to this Court's other extraterritorial taxation cases wherein income was not earned directly from an activity in the taxing state so that the nexus to tax hinged on whether that income was earned in the course of a unitary business, a portion of which occurred in the state. Thus, in *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982), and in *F. W. Woolworth Co. v. Taxation & Revenue Department*, 458 U.S. 354 (1982), nonunitary income in the form of dividends, interest, and capital gains was earned in the course of nondomiciliary parent and subsidiary nonunitary relationships, but the subsidiaries did not have a nexus with the taxing state. Given this lack of nexus, this Court held that there was no basis for the taxing state to assert

taxation of any portion of such income.[3] This Court has never adopted Super Valu's position in this case that income earned as a direct result of activities in the taxing state had to be allocated wholly outside that state to avoid extraterritorial taxation. The diversity of the Super Valu and County Seat businesses does not alter Iowa's constitutional authority to tax a portion of the capital gain.

Super Valu has not and cannot demonstrate by "clear and cogent evidence" that Iowa's tax has resulted in extraterritorial taxation. *Container*, 463 U.S. at 164. The record in this case "is inadequate to evaluate the effect of the [extraterritorial] proposal, its relative impact on [Super Valu], or its potential implications." *Mobil Oil*, 445 U.S. at 441 n.15. For all this record shows, County Seat's Iowa stores could have been highly profitable and contributed more significantly to the appreciation of County Seat stock and, hence, the capital gain, than the non-Iowa stores. Thus, the amount of the gain attributed to Iowa by Iowa's unitary business/formula apportionment method could understate the amount of gain actually attributable to Iowa activities. *Cf. Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272 (1978) (mere possibility of higher profits from Iowa activities militates against extraterritorial taxation). On the basis of the record, Iowa "exerted its power in

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[3] Justice O'Connor noted in *ASARCO* that "[T]he constitutionality of a state tax levied on extraterritorial business operations thus turns on whether the out-of-state business activity can be characterized as a separate business *with no in-state contacts* or whether instead it is a part of a unitary enterprise doing business in the state." 458 U.S. at 334 (O'Connor, J., dissenting) (emphasis added).

relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society" so that there is no showing by Super Valu that Iowa taxed extraterritorially. *Wisconsin v. J. C. Penney*, 311 U.S. 435, 444 (1940).

None of the decisions cited by Super Valu from California, Missouri, and Michigan indicate that those courts considered a situation, as in the instant case, where all of the alleged diverse components of a nondomiciliary enterprise engaged in income-producing activities in the taxing state. (Pet. 10-18). Therefore, from a constitutional extraterritorial taxation standpoint, those state court decisions do not conflict with the Iowa Supreme Court's decision.

Super Valu invites this Court to apply Iowa statutory law of allocation of nonbusiness income under the guise of constitutional adjudication. The Court should decline that invitation.

III. THE IOWA SUPREME COURT'S UNITARY FINDING IS PERMISSIBLE SO THERE IS NO EXTRATERRITORIAL TAXATION.

Even if Super Valu had properly raised and the Iowa Supreme Court had considered the Due Process and Commerce Clause issue of extraterritorial taxation and even if the federal question is not considered insubstantial because of County Seat's Iowa activities, this Court should refuse to grant certiorari. The Iowa Supreme Court employed the appropriate legal standards and carefully considered the facts indicating that a unitary

business existed. This Court should refuse to second-guess the Iowa Court's decision.

This Court has articulated fundamental principles associated with state taxation of multistate enterprises to use in evaluating claims of extraterritorial taxation. "The Due Process Clause places two restrictions on a state's power to tax income generated by the activities of an interstate business. First, no tax may be imposed unless there is some minimal connection between those activities and the taxing state. . . . Second, the income attributed to the state for tax purposes must be rationally related to 'value connected with the taxing state.' " *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-73 (1978). This two-part due process test is also used in consideration of extraterritorial taxation claims under the Commerce Clause. *Trinova Corp. v. Michigan Dept. of Treasury*, 111 S.Ct. 818, 828 (1991); *Amerada Hess Corp. v. Director, Div. of Taxation*, 409 U.S. 66, 80 (1989).

The minimal connection or "nexus" in the state occurs "if the corporation avails itself of the 'substantial privilege of carrying on business' within the state, and '[t]he fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction.' " *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 437 (1980), quoting *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444-45 (1940).

The Court has rejected an argument "that income earned in one state may not be taxed in another" where "the intrastate and extrastate activities formed part of a single unitary business." *Mobil Oil*, 445 U.S. at 438. A

unitary business accounts for "contributions to income resulting from functional integration, centralization of management, and economies of scale" that "arise from the operation of the business as a whole." *Id.* These factors of profitability result "in some sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation."[4] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 166 (1983).

A taxpayer who challenges a unitary finding must show by clear and cogent evidence that it is wrong. *Id.* at 175. The taxpayer is not entitled to a de novo review in this Court of a unitary finding, and the taxpayer's "burden is never met merely by showing a fair difference of opinion which as an original matter might be decided differently." *Id.* at 176, quoting *Norton Co. v. Department of Revenue*, 340 U.S. 534, 537-38 (1951). Unitary challenges, even where stipulations exist, tend to produce "long and complex" factual records, as in the instant case. *Container*, 463 U.S. at 176. This Court's task in such cases is "to determine whether the state court applied the correct standards to the case; and if it did whether its judgment was within the realm of permissible judgment." *Id.* It is obvious "that not every claim that a state court erred in

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[4] Where income is earned by a unitary business, a portion of which is conducted in the taxing state, "the income bears relation to benefits and privileges conferred by" that state so that "apportionment is ordinarily the accepted method" of attributing income to in-state activities. *Mobil Oil*, 445 U.S. at 446.

making a unitary business finding will pose a substantial federal question in the first place." *Id.* n.14.[5]

Given the existence of a unitary business, "the inclusion of [unitary] income in the preapportioned tax base" would "not amount to extraterritorial taxation." *Shell Oil Co. v. Iowa Department of Revenue*, 488 U.S. 19, 30-31 (1988). Thus, if the Iowa Supreme Court decision affirming a unitary finding between Super Valu and County Seat is permissible, Super valu's extraterritorial taxation claim must be rejected.

Super Valu's contention that it lacked a unitary relationship with County Seat must be evaluated "on the record before us." *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 320 (1982). The Court has noted that "the application of the unitary-business principle requires in each case a careful examination both of the way in which the corporate enterprise is structured and operates, and of the relationship with the taxing state." *Id.* at 326 n.22. It is clear from a review of the facts in this case that the Iowa Supreme Court's unitary finding is within the realm of permissible judgment.

Super Valu and County Seat had close managerial and financial links. Five of twelve County Seat officers were officers of Super Valu. (Pet. App. 3a). While none of

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[5] This Court remarked in *Container* that "[I]t will do the cause of legal certainty little good if this Court turns every colorable claim that a state court erred in a particular application of those principles into a de novo adjudication, whose unintended nuances would then spawn further litigation and an avalanche of critical comment." 463 U.S. at 176.

these common officers were involved in day-to-day management of both Super Valu and County Seat, the common officers performed valuable services for County Seat by execution of financial and legal documents, but were only compensated by Super Valu. Super Valu had the authority to hire and fire County Seat's president and did fix the president's compensation. (Pet. App. 11a).

There were common managerial services and oversight provided by Super Valu with respect to retirement plan and employee stock ownership, insurance, payroll processing, internal audit, tax return preparation, marketing services, and legal services. (Pet. App. 33a-35a). Super Valu's type of annual review and approval of County Seat's operating and capital budgets directly affected the number of new County Seat stores that could open. (Pet. App. 11a). This oversight was enhanced by the fact that Super Valu and County Seat shared the same principal office location.

County Seat's retail stores were serviced by two distribution centers in Dallas, Texas, and in Brooklyn Park, Minnesota. Super Valu decided whether these facilities would be constructed because it borrowed all funds for operating and capital usage by it and its subsidiaries. (Pet. App. 32a). Super Valu held title to the Brooklyn Park facility until it sold the County Seat stock. (Pet. App. 32a-33a).

Super Valu, at the request of landlords, furnished guarantees for various County Seat store leases. While Super Valu was never required to satisfy such guarantees, these stores might have been very profitable and not been leased without those guarantees. (Pet. App. 33a).

The initial financing of County Seat was provided by Super Valu. A $22,900,343 seven-year promissory note was not timely paid. Yet, during the period of the note, County Seat expanded from eighty to 269 stores. (Pet. App. 12a).

Super Valu's financial services department operated a centralized cash management system for Super Valu and all subsidiaries. The income and funds of the entire group were pooled to provide working capital to finance the food and clothing businesses. Short-term borrowing and short-term investment were done by Super Valu to provide the group with working capital. (Pet. App. 11a-12a, 34a). The Iowa Supreme Court properly noted that "[A] reasonable conclusion is that County Seat's success was a direct result of this financial nurturing by Super Valu" and "there is evidence to establish that County Seat was largely dependent on Super Valu for its continued financing." (Pet. App. 12a).

During the time that County Seat was a division of Super Valu, Super Valu treated County Seat as part of its unitary apportionable income in Super Valu's Iowa income tax returns. In its financial and corporate reports, Super Valu treated County Seat as part of its trade or business. (Pet. App. 38a).

Despite this clear evidence of managerial and financial integration between Super Valu and County Seat that produced a flow of value indicative of a unitary business, Super Valu urges this Court to adopt a bright-line rule that diverse business components of an economic enterprise are inherently nonunitary. Super Valu erroneously argues that such a bright-line rule is consistent with, if

not required by, this Court's decisions. In particular, Super Valu relies on *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), a case wherein this Court declined to adopt a flow-of-goods bright-line rule. *Id.* at 178-79.

It is true that this Court's unitary decisions have heretofore involved similar businesses. It is not true that horizontal integration that justifies a unitary finding "exists only in the case of corporations that are engaged in the same line of business." (Pet. 19).

A significant part of Super Valu's Petition consists of its argument that the Iowa Supreme Court decision conflicts with this Court's decision in *Container*. There, Container and its foreign subsidiaries manufactured custom-ordered paperboard packaging. There was autonomy between Container and the subsidiaries in day-to-day management and accountability. However, there were significant managerial and financial links. Container held or guaranteed about half of the subsidiaries' long-term debt. Container's managerial role in its subsidiaries' affairs consisted of advice and consultation concerning "manufacturing techniques, engineering, design, architecture, insurance, and cost accounting" and occasional assistance in equipment procurement. *Id.* at 173. This Court held that the California Court was entitled to find that Container and the subsidiaries constituted a unitary business. This Court noted that "a flow of value" was the constitutional prerequisite for a unitary finding. *Id.* at 178.

Super Valu contends that *Container* suggests that diverse businesses, such as its food and clothing businesses,

cannot be unitary. Super Valu relies upon this Court's endorsement, in *Container*, of a rebuttable presumption by the Franchise Tax Board that corporations in the same business are unitary.[6] *Id.* In support of this presumption, this Court stated that a corporation's investment in a discrete diverse business "often serves" a primary corporate portfolio diversification function thereby reducing risks that inhere in the main corporate business. *Id.* There was no showing by Super Valu of such risk reduction motive in this case. Conversely, a corporate investment "in the same line of work" is "much more likely" to "make better use – either through economies of scale or through operational integration or sharing of expertise – of the parent's existing business-related resources." *Id.*

The Iowa Supreme Court's decision is not inconsistent with that presumption or its underlying rationale. The fact that corporations in the same type of business are more likely to be unitary than corporations which are not does not mean that diverse corporations are never unitary. Super Valu's statement that managerial and financial links have a different import for corporations in the same business than for those engaged in diverse businesses (Pet. 21) ignores the fundamental principle in *Container* that a unitary finding is grounded upon flows

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[6] The mere fact that corporations are in the same business does not lead to a conclusion that they have a unitary relationship. *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F. W. Woolworth Co. v. Taxation and Revenue Department*, 458 U.S. 354 (1982).

of value.[7] Where, as in this case, flows of value exist as a result of the integration of managerial and financial resources between Super Valu and County Seat, it makes no sense to dismiss them as meaningless because they arose in a relationship between diverse businesses.

In *Container*, this Court said that "the resulting flow of value is obvious" with respect to "the flow of capital resources from appellant to its subsidiaries through loans and loan guarantees" which served an operational purpose, and not a mere investment purpose. *Id.* at 180 n.19. The flow of capital resources between Super Valu and County Seat served operational purposes. Through Super Valu's centralized cash management, borrowings, and investments, Super Valu and County Seat pooled financial resources that ensured growth and stability in the food and clothing businesses. These conditions do not support a view that there was a "mere flow of funds arising out of a passive investment or a distinct business operation" that would preclude a unitary finding. *Id.* at 166. Instead, they lead to the conclusion that "one's stable operation is important to the other's full utilization of capacity." *Woolworth*, 458 U.S. at 370.

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[7] Super Valu errs both in its claim that there is a lack of functional integration between Super Valu and County Seat and that such absence forecloses a unitary finding. In *F. W. Woolworth Co. v. Taxation & Revenue Department*, 458 U.S. 354 (1982), this Court considered whether the factors of functional integration, centralization of management, and economies of scale were present. Although the Court found insufficient functional integration, the Court then considered "the extent to which there was centralization of management or achievement of economies of scale." *Id.* at 366. Such consideration would have been unnecessary if a lack of functional integration alone precluded a unitary finding.

Super Valu's managerial role in County Seat's affairs was extensive and nurtured County Seat's growth. Super Valu did not merely exercise "occasional oversight" over County Seat. (Pet. 22). Super Valu neither treated County Seat as a passive investment nor as a "discrete business enterprise" that is "distinct in any business or economic sense" from Super Valu's food business. *Mobil Oil*, 445 U.S. at 439.

The Iowa Supreme Court applied the legal principles articulated by this Court in unitary cases and its unitary finding is within the realm of permissible judgment. To ignore the economies of scale in the Super Valu-County Seat interaction and rely upon Super Valu's dogmatic diverse business bright-line rule of nonunity would be unrealistic and wrong.

CONCLUSION

For the above stated reasons, the Department respectfully requests that the Petition for Writ of Certiorari be denied.

Respectfully submitted,

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APPENDIX

APPENDIX A

BEFORE THE IOWA STATE DEPARTMENT
OF REVENUE AND FINANCE
HOOVER STATE OFFICE BUILDING
DES MOINES, IOWA

IN THE MATTER OF

SUPER VALUE STORES, INC.
P.O. Box 990
Minneapolis, MN 55440

CORPORATE INCOME
TAX ASSESSMENT

DOCKET No.
86-510-2A-A

BRIEF OF TAXPAYER
SUPER VALU STORES, INC.

John W. Windhorst, Jr.
Mary J. Streitz
DORSEY & WHITNEY
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Telephone: (612) 340-2645/7813

Attorneys for Taxpayer

* * *

ARGUMENT

A. The Tax Treatment of The Capital Gain Turns on Whether Super Valu and County Seat Were Part of The Same "Unitary Business"

This case concerns the proper treatment under Iowa law of Super Valu's capital gain on the sale of the County

Seat stock. Iowa's income tax statute provides that nonbusiness capital gain from the sale of stock and other intangible personal property is allocable to Iowa (*i.e.*, taxable in its entirety by Iowa) if the taxpayer's commercial domicile is in Iowa. Iowa Code § 422.33, subsec. 2(a)(4). This provision is inapplicable to the present case because it is undisputed that Super Valu's commercial domicile is in Minnesota. The statute also provides, however, that such capital gain is includible in apportionable income if it is business income. *See id.* § 422.33, subsec. 2(b); Iowa Admin. Code § 701-54.2 (442). The issue here, therefore, is whether Super Valu's gain is business income.

On its Iowa income tax return for the Taxable Year, Super Value reported the gain as nonbusiness capital gain within the meaning of Iowa Code § 422.33, subsec. 2(a)(4). Because Super Valu's commercial domicile is in Minnesota, the gain was allocable to Minnesota. The Tax Review Committee of the Department determined that Super Valu should have reported the gain as business income.

Iowa Admin. Code § 701-54.2 (442) provides that the question whether long-term capital gain is business income depends on all of the facts and circumstances and is to be determined under the principles set forth in the United States Supreme Court cases of *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) ("*Mobil*"); *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982) ("*ASARCO*"); *F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico*, 458 U.S. 354 (1982) ("*Woolworth*"); and *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983) ("*Container*").

Taken together, these cases (1) hold that dividend and capital gain income attributable to stock owned by a corporation in another corporation is business income and therefore includible in apportionable income only if the two corporations are part of the same "unitary business" and (2) define the "unitary business" concept. *See, e.g., ASARCO*, 458 U.S. at 330 (taxability of capital gain from sale of stock and of dividends paid with respect to stock must be resolved under same unitary business standard).[1]

B. The Most Important Indicator of a Unitary Business is Lacking Because Super Valu and County Seat Were Not Operationally Integrated

The Supreme Court cases cited in the Iowa Rule make clear that the fact that a corporation uses the proceeds of the sale of stock in another corporation (or amounts received as dividends) for working capital or for other business purposes is irrelevant to the question whether the corporations are part of the same unitary

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[1] In citing *Container*, a case involving combined reporting, the Iowa Rule acknowledges that the same standards apply in determining whether a unitary business exists for combined reporting purposes as for the purpose of classifying dividends and capital gains as business income subject to apportionment. *See also Appeal of Fibreboard Corp.*, Cal. Bd. Equal., January 6, 1987 (Cal. CCH ¶ 401-459) (in case of parent and wholly-owned subsidiary, "business income" test for apportionment purposes is substantially identical to "unitary business" test for combined reporting purposes).

APPENDIX B

IN THE DISTRICT COURT OF THE
STATE OF IOWA FOR POLK COUNTY

SUPER VALU STORES, INC.	)	
	)	
Petitioner	)	CASE NO.
	)	AA-1571
v.	)	
	)	
DEPARTMENT OF REVENUE AND FINANCE	)	(Filed Mar. 13, 1990)
	)	
Respondent	)	

BRIEF OF DEPARTMENT OF REVENUE AND FINANCE

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* * *

ARGUMENT

I. STANDARD OF REVIEW

In this judicial review of final agency action, the District Court functions in an appellate capacity to correct errors of law on the part of the Department. *Northwestern Bell Telephone Co. v. Iowa State Commerce Comm'n*, 359 N.W.2d 491, 495 (Iowa 1984); *Kartridg Pak Co. v. Department of Revenue*, 362 N.W.2d 557, 559 (Iowa 1985).

The Court's review is limited to the record made before the Department. *Maschino v. Geo. A. Hormel & Co.*, 372 N.W.2d 256, 258 (Iowa 1985). Evidence is substantial to support the Department's contested case decision if a reasonable person would find it adequate to reach the given conclusion, even if a reviewing court might draw a contrary inference. *Mercy Health Center, a Div. of Sisters of Mercy Health Corp. v. State Health Facilities Council*, 360 N.W.2d 808, 811-12 (Iowa 1985). The Court should accord proper respect for the expertise of the administrative agency. *Iowa Health Systems Agency, Inc. v. Wade*, 327 N.W.2d 732, 733 (Iowa 1982).

In the instant case, this Court must determine whether the Director could permissibly find that the capital gain in question constituted business income under Iowa Code § 422.33(2) (b) (2). This boils down to whether the Director properly determined whether Super Valu and County Seat had a unitary relationship.[4]

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[4] Super Valu, in footnote 7 at page 8 of its Brief, states that the Department's contention that Super Valu failed to raise the Constitutional Due Process and Commerce Clause issues of extraterritorial taxation in the administrative contested case proceeding is "frivolous." Super Valu's citation to paragraph 15 of its Protest as a basis for arguing it has preserved these issues is meritless. Paragraph 15 makes only a general constitutional allegation that lack of functional integration, centralized management, and economics of scale preclude the capital gain from being part of Super Valu's business income. This is insufficient to particularize a constitutional issue. *McSpadden v. Big Ben Coal Company*, 288 N.W.2d 181, 184 (Iowa 1980). More importantly, in the contested case proceeding, a constitutional issue was never really pursued by Super Valu in its Briefs or in

(Continued on following page)

This Court's review, as an Appellate Court, is the same as that articulated by the Supreme Court in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 176, 77 L.Ed.2d 545, 560, 103 S.Ct. 2933 (1983) in which the Supreme Court stated:

> Rather, our task must be to determine whether the [Department] applied the correct standards to the case; and if it did, whether its judgment
>
> * * *

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its evidentiary presentation and was not considered by the agency. It cannot be raised here for the first time. *See Grudle v. Iowa Department of Revenue*, N.W. 2d (Iowa 1990).

In the Supreme Court cases cited in Department rule 701 Iowa Admin. Code 54.2, it was clear that the subsidiary associated with the alleged unitary income did not do business in the taxing state. Therefore, the state lacked constitutional power to attribute any nonunitary income to instate activities. By contrast, County Seat had 10 stores in Iowa when sold by Super Valu. From a constitutional standpoint, some of the capital gain could have been attributed to and taxed by Iowa. Iowa, by electing to apply unitary business principles to define business income and by allocating nonbusiness capital gains from sales of intangibles to corporate domicile of the foreign multistate corporation, has not taxed to the fullest extent of its constitutional authority. Since the record does not develop whether Iowa would, in fact, overreach even if the disputed capital gain is nonunitary income, there is simply no basis for this Court to concluded that inclusion of Super Valu's capital gain in its apportionable income violated Due Process or the Commerce Clause. *See Silent Hoist & Crane Co. v. Director, Division of Taxation*, 100 N. J. 1, 494 A.2d 775, 780 (1985). Accordingly, the Court should not consider any "constitutional" issues in its judicial review of the Director's Order.

APPENDIX C

IN THE SUPREME COURT OF IOWA

No. 90-1557

SUPER VALU STORES, INC.,
Petitioner-Appellant

vs.

DEPARTMENT OF REVENUE
AND FINANCE,
Respondent-Appellee

APPEAL FROM THE DISTRICT COURT
OF POLK COUNTY
HON. JACK D. LEVIN, JUDGE

APPELLEE'S BRIEF

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APPELLEE

* * *

ARGUMENT

THE FINAL CONTESTED CASE ORDER DID NOT ERR, AS A MATTER OF LAW, IN ITS DETERMINATION THAT THE CAPITAL GAIN IN QUESTION CONSTITUTED BUSINESS INCOME.

A. STANDARD OF REVIEW

In this judicial review of final agency action, the Court functions in an appellate capacity to correct errors of law on the part of the Department. *Northwestern Bell Telephone Co. v. Iowa State Commerce Com'n*, 359 N.W.2d 491, 495 (Iowa 1984); *Kartridg Pak Co. v. Department of Revenue*, 362 N.W.2d 557, 559 (Iowa 1985).

In the instant case, this Court must determine whether the Director as a matter of law could not permissibly find that the capital gain in question constituted business income under Iowa Code § 422.33(2) (b) (2). This boils down to whether the Director used the correct legal standard to determine whether Super Valu and County Seat had a unitary relationship and, given such standard, whether the Director could find, as a matter of permissible judgment, that Super Valu and County Seat had a unitary relationship.[4]

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[4] Super Valu states that there is a Due Process and Commerce Clause constitutional issue of extraterritorial taxation properly before the Court. Super Valu Brief at 21. There is no such issue in this case. Super Valu did not brief or argue such an issue in the contested case proceeding and it cannot be presented in the District Court or here. *Grudle v. Iowa Department of Revenue and Finance*, 450 N.W.2d 845 (Iowa 1990); *Hope Evangelical Church v. Iowa Department of Revenue and Finance*, N.W.2d (Iowa 1990).

(Continued on following page)

This Court's task in this case, as an Appellate Court, is the same as that articulated by the Supreme Court in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 176, 77 L.Ed.2d 545, 560, 103 S.Ct. 2933 (1983) in which the Supreme Court stated:

> Rather our task must be to determine whether the [Department] applied the correct standards to the case; and if it did, whether its judgment "was within the realm of permissible judgment."

* * *

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Unlike the situations in the Supreme Court cases cited in Department rule 701 Iowa Admin. Code 54.2, whereby the subsidiaries did no business in the taxing state, the County Seat subsidiary had 10 stores in Iowa when sold by Super Valu. As a consequence, Iowa, unlike the cases cited in the rule, has the constitutional power to tax a part of the capital gain without violating extraterritorial principles of taxation. By electing to be bound in its *statutes* to the unitary principles for determining and allocating nonbusiness capital gains from sales of intangibles to the foreign corporate domicile, Iowa has foregoed taxation to the full extent of its constitutional power. Since the record does not show whether Iowa's taxation by formula apportionment of a portion of the disputed capital gain would be unconstitutional extraterritorial taxation, even if the gain is held to be nonunitary income, there is no basis for this Court to conclude that Iowa's tax is unconstitutional. Accordingly, there are no constitutional issues for the District Court or this Court to review. None were addressed by the Director. A general unconstitutional allegation by Super Valu in its Protest that was not really pursued in the contested case proceeding is inadequate to preserve any constitutional issue on this judicial review.